

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of)
)
Elimination of Rate-of-Return Regulation of) RM-____
Incumbent Local Exchange Carriers)
)
Federal-State Joint Board on Universal) CC Docket No 96-45
Service)
)

PETITION FOR RULEMAKING TO
ELIMINATE RATE-OF-RETURN REGULATION
OF INCUMBENT LOCAL EXCHANGE CARRIERS

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10-31-03

**Western Wireless Petition for Rulemaking
To Eliminate Rate-of-Return Regulation of ILECs**

Top Ten Reasons to Eliminate Rate-of-Return ("ROR") Regulation

- 1 **Save Money.** By far the largest cause of the growth of the high-cost universal service fund is disbursements to rural ILECs pursuant to ROR formulas. Consumers across the country would save hundreds of millions, possibly billions, of dollars if ROR were eliminated and replaced with a system better targeted to support affordable service for consumers in high-cost areas.
- 2 **Stop Waste, Fraud and Abuse.** Regulators and independent auditors rarely, if ever, look at the accounting books of most ROR carriers, and opportunities abound for carriers to overstate their costs and thereby increase their access charges and high-cost support. The Supreme Court recognized that the ILECs' "book costs may be overstated by approximately \$5 Billion" [*Verizon v. FCC*, 535 U.S. 467, 518 (2002)].
- 3 **Prevent Cross-Subsidies and Cost Misallocation.** In the few cases where the FCC or a state commission examined carriers cost submissions, they found millions of dollars of misallocated costs including costs of unregulated affiliates assigned to the ILEC in order to inflate high-cost support. In most cases, the FCC may lack authority to order remedies for such over-earnings. "In an era of corporate governance problems and accounting depredations," [Adelstein/Copps statement, FCC 03-111, 5/19/03], the FCC should change the rules to eliminate the rewards for such anti-competitive misconduct.
- 4 **Create Incentives for Efficiency.** ROR regulation gives carriers incentives "to adopt the most costly, rather than the most efficient, investment strategies," [3 FCC Rcd 3195, 3219-20]. Ending ROR would create incentives for more efficient networks, and would benefit consumers.
- 5 **Enhance Incentives for Innovation.** The FCC has recognized that ROR "may have a negative effect on innovation . . . because a carrier's reward for such innovation is a reduction in its dollar earnings" [3 FCC Rcd 3195, 3223]. Eliminating ROR regulation would enhance incentives to speed the deployment of new technologies, benefitting rural consumers.
- 6 **Remove Barriers to Competition in Rural Areas.** Rural customers benefit from access to competitive telecom alternatives, but ROR regulation is a barrier to full competition. ROR targets RLECs' revenues to achieve a guaranteed return on investment on all historical costs incurred, while the RLECs' competitors receive portable funding only if they can obtain ETC designation, and even then only with respect to the lines that they provide – and unlike the RLECs, competitive carriers' investments are at risk.
- 7 **Fix Distorted Inter-carrier Compensation.** Eliminating ROR would enable the FCC to remove implicit subsidies from the RLECs' access rates, as the Act requires. The RLECs' current, unreasonably high access charges distort local and long-distance competition in rural areas, deprive rural consumers of access to long-distance alternatives, and interfere with the development of a comprehensive rational system of inter-carrier compensation.
- 8 **Rationalize and Modernize High-Cost Support.** The current high-cost support system is an irrational hodge-podge that gives rural ILECs vastly more support than larger carriers for serving

identical geographic areas, rewards them simply for being small, and ignores whether they are efficient or not. The ROR paradigm must be replaced with a competitively neutral system that ensures “sufficient funding of *customers*, not *providers*,” as the 1996 Act requires. [*Alenco*, 201 F.3d 608, 620 (5th Cir. 2000)]

9. **Remedy Unhealthy Dependence of RLEC Sector.** Many RLECs receive 70% or more of their funding from universal service subsidies or intercarrier payments, rather than from their own customers. This unhealthy dependence insulates these carriers from any incentive to be responsive to their own consumers’ needs. Eliminating ROR and rebalancing rates would put these carriers on a healthier financial footing.
10. **The FCC Was Correct and Should Keep Its Promises.** In the 2001 *RTF Order*, the FCC reaffirmed its 1997 commitment to adopting forward-looking cost-based support mechanisms for rural carriers. It is time for the Commission to deliver on this worthy commitment.

In sum, ROR regulation bloats the universal service fund, creates opportunities and incentives for waste, fraud and abuse, and inhibits the development of efficient, innovative, and competitive services for rural consumers. ROR regulation has outlived its time and must be replaced with a more appropriate form of regulation based upon today’s competitive environment.

* * * * *

Western Wireless proposes to replace ROR regulation with a forward-looking cost-based system to determine universal service high-cost support and access charge rate levels.

- **Cost Methodology.** Develop a model or other cost analysis methodology that accurately estimates the forward-looking cost of wireline service in high-cost areas. Develop a similar model or other methodology to estimate the forward-looking cost of *wireless* service. Support would be based on the lower of the wireline or wireless forward-looking cost in each geographic area.
- **Support Methodology.** Provide two types of support: the first based on a simple comparison of the cost of service with a national benchmark, and the second based on statewide averages. As an inducement to rate rebalancing and eliminating implicit subsidies in retail rates, limit support to carriers with retail rates that are below minimum “affordable” levels.
- **Phase In the New System.** Implement the new rules in 2006 (at the end of the 5-year period provided by the *RTF Order*) for competitive ETCs, non-rural ILECs, and rural ILECs owned by relatively large holding companies. Phase in the rules over the following 6 years for smaller rural ILECs.
- **Establish “Safety Net” and “Hold Harmless” Mechanisms.** To avoid rate shock, implement the plan so that no study area loses more than a specified percentage of the amount of support it previously received in any one year. Offer additional support if a carrier can prove that the forward-looking support amount is insufficient given its particular circumstances.
- **Reform Access Charges.** Rebalance access charges by moving non-traffic sensitive costs and other implicit subsidies out of access charges paid by long-distance carriers, and into subscriber line charges. Set RLEC access rates based on forward-looking costs, price cap mechanisms, and/or generic intercarrier compensation rules.

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ATTACHMENT A “Rate of Return Regulation:
Problems That Can No Longer Be Ignored”

ATTACHMENT B “Rate of Return Regulation:
A Failed Model For Economic Regulation”

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**PETITION FOR RULEMAKING
TO ELIMINATE RATE-OF-RETURN REGULATION
OF INCUMBENT LOCAL EXCHANGE CARRIERS**

Western Wireless Corporation ("Western Wireless"), by counsel and pursuant to Section 1401 of the Commission's rule, hereby submits this Petition for Rulemaking to eliminate rate-of-return ("ROR") regulation of rural incumbent local exchange carriers ("RLECs"), for purposes of determining their federal high-cost universal service support and interstate access charges. This petition seeks to facilitate the transformation of the local telecommunications market from a monopoly to a competitive environment by replacing a highly inefficient, non-competitive system of regulation with an efficient, competitively neutral approach to regulating RLECs. By granting this Petition, the Commission will release rural consumers from the monopoly grips of the RLECs, whose dominant position in the local market threatens the ability of rural America to have access to basic and advanced services comparable to those available in urban areas.

As the Commission has previously recognized “rate of return regulation provides regulated firms with very strong incentives to pad their rates,” leads them “to adopt the most costly, rather than the most efficient, investment strategies because its primary means of increasing dollar earnings under rate-of-return constraints is to enlarge its rate base,” and “may have a negative effect on innovation . . . because a carrier’s reward for such innovation is a reduction in its dollar earnings.” ^{1/} Moreover, ROR regulation is based on an outdated monopoly paradigm of guaranteeing that a favored group of carriers “recover their investment in the total network facilities needed” ^{2/} This paradigm of protecting selected carriers’ investments must be replaced with a paradigm of ensuring “sufficient and competitively-neutral funding to enable all customers to receive basic telecommunications services,” since the 1996 Act “requires sufficient funding of *customers, not providers*.” ^{3/} ROR regulation has outlived its time and must be replaced with a more appropriate form of regulation based upon today’s competitive environment.

I. INTRODUCTION AND SUMMARY

Western Wireless provides commercial mobile radio service (“CMRS”) in 18 Metropolitan Statistical Areas (“MSAs”) and 88 Rural Service Areas (“RSAs”)

^{1/} *Policy and Rules Concerning Rates for Dominant Carriers*, Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195, 3219-20, 3223, ¶¶ 39, 46 (1988) (“*Price Cap FNPRM*”).

^{2/} National Telecommunications Cooperative Association (“NTCA”) Initial Comments, CC Docket No. 96-45 (Joint Board Portability Proceeding) (filed May 5, 2003), at 7.

^{3/} *Alenco Communications, Inc. v. FCC*, 201 F.3d 608, 620 (5th Cir. 2000) (“*Alenco*”) (emphasis in original).

in 19 states. The Company has also been designated as an eligible telecommunications carrier ("ETC") in 14 states, plus the Pine Ridge Indian reservation. More and more consumers today rely on wireless services for the telecommunications needs. Wireless and wireline services are becoming largely interchangeable, with both services increasingly competing to serve a consumer's telecommunications needs. The ability of Western Wireless to effectively compete with the RLECs is seriously compromised by a system of regulation – Rate-of-Return regulation – that essentially guarantees the RLECs' dominant position in the marketplace.

Western Wireless, like any business in a competitive environment, takes investment risks and receives revenues only to the extent that it is able to attract customers. By contrast, RLECs are the beneficiaries of ROR regulation that provides them a perceived entitlement to recover all their operating expenses and depreciation on capital expenditures, plus a specified rate of return on investment. Western Wireless and other competitive carriers operate in a much different market, a market without entitlements, guarantees, or immunity from marketplace forces. In the competitive market in which Western Wireless operates, consumers determine a carrier's fate.

As explained below, ROR regulation disserves the public interest by inhibiting competition, enabling incumbent carriers to maintain a dominant position in the local exchange market, and creating an inefficient universal service

funding mechanism that is growing too fast and exposes the public to serious risks of fraud and abuse

First, the system of ROR regulation, designed for a monopoly environment, has no place in an environment of local competition. The ROR system targets RLECs' access rates and high-cost support to achieve a guaranteed return on investment on all historical costs incurred, while RLECs' emerging ETC competitors receive funding only on a per-line basis for those lines served. Unlike incumbent carriers, competitive entrants' investments are at risk. ROR regulation's reliance on the RLECs' historical costs is also inconsistent with the advent of local competition, since – as the Commission has long recognized, and as the Supreme Court recently affirmed, forward-looking costs are the only true measure of the factors that drive economic decision-making

Second, as the Commission has repeatedly recognized, ROR regulation interferes with incentives for carriers to operate efficiently, deploy new technologies, and reduce their operating costs. In today's increasingly competitive environment, it makes no sense to retain a system that gives carriers incentives to operate inefficiently and discourages them from introducing technological innovations. The ROR system, which rewards carriers for being small and inefficient, also creates artificial and inefficient incentives for RLECs to remain as small as possible, and for larger ILECs to sell exchanges to smaller carriers, even if

it would be economically efficient for RLECs to combine or for larger carriers to operate those exchanges 4/

Third, ROR regulation is the true cause for the growth of the high-cost universal service fund, which threatens the long-term viability of the fund. A universal service funding mechanism based upon ROR regulation, the almost complete lack of independent oversight over the RLECs' cost reporting, and legal restrictions on the Commission's ability to require refunds or other remedies if and when it detects ROR over-earnings, leaves the public exposed to a very serious risk of fraud, waste, and abuse. In this "era of corporate governance problems and accounting depredations," 5/ this risk should be unacceptable. 6/

This petition proposes eliminating and replacing ROR regulation of the larger RLECs beginning in 2006, and of smaller carriers over a gradual transition

4/ Ideally, regulation should neither create incentives for concentration nor create incentives for de-concentration, but should allow the marketplace to determine the optimal size of telecommunications carriers.

5/ *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, Further Notice of Proposed Rulemaking, WC Docket No. 02-112, FCC 03-111 (released May 19, 2003) (separate statement of Commissioner Michael J. Copps and Commissioner Jonathan S. Adelstein, concurring). See also *2002 Regulatory Review - Requirements Governing the NECA Board of Directors under Section 69.602 of the Commission's Rules and Requirements for the Computation of Average Schedule Payments under Section 69.606 of the Commission's Rules*, Report and Order, CC Docket No. 01-174, FCC 03-151 (released July 3, 2003) (statement of Commissioner Michael J. Copps dissenting).

6/ In Attachment A to this Petition ("Rate of Return Regulation - Problems That Can No Longer Be Ignored") we supply evidence of such malfeasance that state commissions in California, Kansas, and other states have identified. This information builds on additional evidence in a report submitted with Western Wireless' Reply Comments filed June 3, 2003 in the *Joint Band Portability Proceeding*, and included as Attachment B to this Petition ("Rate of Return Regulation - A Failed Model for Economic Regulation"). Moreover, record evidence already before the FCC shows that ROR ILECs earned at least \$400 million of dollars in excess of what the existing ROR system allows over the past few years. See AT&T Ex Parte Filing, CC Docket Nos. 00-256, 96-45, 98-77, and 98-166 (filed May 9, 2003).

period in subsequent years. This petition also calls for instituting extensive new safeguards during the transitional time period during which ROR will remain in effect. The time is right for a rulemaking to replace ROR regulation, particularly in light of the following closely related, pending and soon-to-be-initiated rulemaking proceedings:

- First, the rulemaking proposed here is closely related to the pending *Joint Board Portability Proceeding*, which addresses “the methodology for calculating support for ETCs” – including incumbent as well as competitive ETCs – “in competitive study areas.” ^{7/} This rulemaking proceeding would develop a comprehensive record for the establishment of a new high-cost support system for all ETCs in lieu of ROR regulation and would be helpful in addressing issues in the pending *Joint Board Portability Proceeding*. Given the relationship among these issues, Western Wireless would support a referral to the Federal-State Joint Board on Universal Service of many of the issues discussed here. Western Wireless would also support referral of related separations issues to the Federal-State Joint Board on Separations.
- Second, the rulemaking sought here raises issues that are highly relevant to the forthcoming “comprehensive review of the high-cost mechanisms for rural and non-rural carriers as a whole,” in which the Commission has committed to “consider all options, including the use of forward-looking costs, to determine appropriate support levels for both rural and non-rural carriers.” ^{8/}
- Third, the rulemaking sought here dovetails with the Further Notice of Proposed Rulemaking accompanying the *Tenth Circuit Remand Order*, in which the Commission seeks comment on additional targeted federal support to advance the goal that “states [] be encouraged to replace implicit support with explicit support mechanisms that will be sustainable in a competitive environment,” which should help “achieve Congress’ universal service goals by creating an explicit support fund

^{7/} *Portability Referral Order*, 17 FCC Rcd at 22645-46, ¶ 7, *Joint Board Portability Public Notice*, 18 FCC Rcd at 1948, ¶ 15.

^{8/} *Federal-State Joint Board on Universal Service*, Fourteenth Report and Order, 16 FCC Rcd 11244, 11310, ¶ 169 (2001) (“*RTF Order*”).

to benefit consumers who need it and by eliminating the vestiges of implicit support that misallocate resources and distort competition.” 9/

- Fourth, a rulemaking proceeding to eliminate ROR regulation will help the Commission achieve its objectives with regard to intercarrier compensation. 10/ Eliminating ROR regulation of the RLECs’ access charges will enable the Commission to eradicate the implicit subsidies currently embedded in those rates, as the Act requires. 11/ It will also help the Commission to end the economic distortions in the local and long-distance marketplace caused by the RLECs’ excessive access rates
- Finally, the recently opened Total Element Long-Run Incremental Cost (“TELRIC”) review proceeding will address forward-looking costing questions that may also be relevant to the development of a new forward-looking cost-based universal service support system for RLECs, non-rural incumbent carriers and competitive ETCs. 12/

9/ *Federal-State Joint Board on Universal Service, Order on Remand, Further Notice of Proposed Rulemaking, and Memorandum Opinion and Order*, CC Docket No. 96-45, FCC 03-249, ¶ 127 (“*Tenth Circuit Remand Order FNPRM*”) (released Oct. 27, 2003), *id.*, Separate Statement of Chairman Michael K. Powell, at 1.

10/ *Developing a Unified Intercarrier Compensation Regime*, Notice of Proposed Rulemaking, 16 FCC Rcd 9610 (2001) (“*Intercarrier Compensation Notice*”). The *Intercarrier Compensation Notice* specifically sought comment on moving the access charges of all local exchange carriers, including RLECs subject to ROR regulation, toward a bill-and-keep system. *Id.*, 16 FCC Rcd at 9644-45, ¶ 97. It also addressed the possible impact of such reforms on end-user rates and universal service support mechanisms. *Id.*, 16 FCC Rcd at 9654-55, ¶¶ 123-24.

11/ *Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393, 406 (5th Cir. 1999), *Alenco*, 201 F.3d at 624, *Texas Office of Public Utility Counsel v. FCC*, 265 F.3d 313, 318 (5th Cir. 2001).

12/ *Review of the Commission’s Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Services by Incumbent Local Exchange Carriers*, Notice of Proposed Rulemaking, 18 FCC Rcd 18945 (2003) (“*TELRIC NPRM*”). To be sure, the forward-looking economic cost methodology used for pricing network elements is different in important respects from the forward-looking economic cost model used in the context of universal service support, and the two methodologies need not be identical. *TELRIC NPRM*, ¶ 46, *Federal-State Joint Board on Universal Service, Tenth Report and Order*, 14 FCC Rcd 20156, 20172, ¶ 32 (1999) (“*USF Inputs Order*”), *aff’d sub nom. Qwest Corp. v. FCC*, 258 F.3d 1191 (10th Cir. 2001). Nonetheless, there are important methodological and input questions that could affect both network element pricing and universal service, in particular the models and inputs used to determine forward-looking costs.

We offer herein a brief history of ROR regulation, including the FCC's stated commitment to transition all high-cost universal service support to a forward-looking system. Next, we provide more detailed support for why the obsolete and anti-competitive system of ROR regulation should be brought to an end as expeditiously as possible. We discuss possible replacements for ROR regulation, including a forward-looking economic cost-based system to set high-cost universal service funding amounts in rural areas, and rate rebalancing and an overhaul of RLEC access charges as part of comprehensive intercarrier compensation reform. Finally, we offer a transition plan for phasing out ROR regulation and introducing a system of regulation based on forward-looking economic cost.

As demonstrated herein, ROR regulation has outlived its usefulness. Now is the time for the Commission to initiate a rulemaking proceeding to eliminate ROR regulation of the RLECs and replace it with a new system based on forward-looking economic costs.

II. BACKGROUND

A. Rate-Of-Return Regulation Has Its Historical Roots In The Era Of Monopoly Local Telephone Service That No Longer Exists

ROR regulation based on historical, embedded costs was first introduced in the context of regulating a monopoly power company's return on investment. In 1944, the Supreme Court upheld the Federal Power Commission's decision to use ROR regulation based on historical costs, and rejected a utility's argument that the agency should have used a "fair value" (based on reproduction costs) methodology (one form of what is now referred to as a forward-looking

economic cost methodology) ^{13/} The Supreme Court, however, specifically rejected the notion that ROR is the only legally permissible approach to regulating even in a monopoly environment

It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. * * * [T]o declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates. It has repeatedly been stated that no single method need be followed by the Commission in considering the justness and reasonableness of rates ^{14/}

The FCC did not begin to formally develop its ROR system for regulating the then-monopoly incumbent local exchange carriers ("ILECs") until the mid-1960s, and conducted a number of major ROR ratemaking proceedings regarding the Bell System during the 1960s, 1970s and early 1980s ^{15/} However, the Commission never directly regulated the costs or rates of the small and mid-size ILECs (also known as "independent" carriers because they were not affiliated with the pre-divestiture Bell system). Prior to divestiture, the independent ILECs

^{13/} *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944)

^{14/} *See id.* at 602, 609. *See also* *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989); *Verizon Communications, Inc. v. FCC*, 535 U.S. 467, 497-501 (2002) ("*Verizon v. FCC*") (affirming FCC's use of forward-looking costs as the basis for setting UNE rates), *Alenco*, 201 F.2d at 620 ("The Act only promises universal service, and that is a goal that requires sufficient funding of customers, not providers. So long as there is sufficient and competitively-neutral funding to enable all customers to receive basic telecommunications services, the FCC has satisfied the Act and is not further required to ensure sufficient funding of every local telephone provider as well.") (emphasis in original)

^{15/} *Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873, 2884-89, ¶¶ 18-28 (1989) ("*AT&T Price Cap Order*") (describing history of ROR regulation)

received a share of long-distance revenues from the monopoly long-distance carrier, AT&T, through a “settlements” process that was “industry devised” and barely, if at all, overseen by the Commission ^{16/} The ILECs simply reported their costs to AT&T or its Bell company affiliates, which reviewed their cost studies, albeit with no independent regulatory oversight, and a settlement amount was negotiated

What the Commission *did* oversee, beginning in the 1960s, was the Separations Manual, which controlled the allocation of costs between the state and interstate jurisdictions ^{17/} The Separations Manual was utilized as an elaborately complex mechanism to funnel implicit universal service subsidies from long-distance to local rates. ^{18/} The separations rules (now in Part 36) continue to serve that purpose to this day

The system of “division of revenues” and “settlements” became unsustainable with the emergence of long-distance competition. Thus, the FCC replaced that system with access charges, and created the National Exchange Carrier Association (“NECA”), consisting of ILEC members and run by the ILECs’

^{16/} *MTS and WATS Market Structure*, Notice of Inquiry and Notice of Proposed Rulemaking, 67 FCC 2d 757, 759, ¶ 8 (1978). Similarly, AT&T’s ILEC affiliates – the Bell Operating Companies – received a share of long-distance revenues through a “division of revenues” process

^{17/} See *American Telephone & Telegraph Co. and the Associated Bell System Companies Charges for Interstate and Foreign Communication Service*, 9 FCC 2d 30, 90, ¶ 246 (1967) (first Commission order addressing separations rules) (“Although the content of the ‘Separations Manual’ is the product of cooperative studies and consultations involving the NARUC, this Commission and the telephone industry, [prior to this order] it has never been formally evaluated, approved, or adopted by this Commission in the context of either a ratemaking or rulemaking proceeding.”)

^{18/} See generally P. Huber, M. Kellogg, and J. Thorne, *Federal Telecommunications Law* 130-40 (2d ed. 1999).

representatives, ^{19/} to take over certain functions previously handled by AT&T. tariff coordination, monitoring of individual ILECs' cost studies, development of averaged rates, and pool administration. No independent regulatory authority ever thoroughly reviewed the cost submissions by the small, independent ILECs, although the FCC exercised a degree of oversight over NECA's tariff filings and other operations.

Gradually, the rules were relaxed, and the larger ILECs were permitted to exit from NECA's rate pools and averaging. However, three mechanisms were established to preserve the pre-divestiture subsidies that the small, independent ILECs had enjoyed under the old "settlements" system. After the 1996 Act was enacted, contributions from the telecommunications carriers became the source of funding for these mechanisms (replacing some, but not all, of the interstate access charges paid by long-distance carriers). The disbursement rules for rural ILECs, however, remain essentially the same as they were prior to 1996, with only minimal exceptions, such as.

- First, for rural ILEC study areas that reported loop costs that were above the national average, the ILEC was allowed to recover a significantly higher proportion of its loop costs than it would have received under the standard separations rules. This mechanism, originally known simply as the "Universal Service Fund," survives today as "High-Cost Loop" support, and amounts to over \$1.1 billion annually. ^{20/}

^{19/} See 47 C.F.R. Part 69, Subpart G (rules governing NECA membership and board).

^{20/} See 17 C.F.R. Part 36, Subpart F. The support amounts listed in this and the following text are drawn from the Universal Service Administrative Co.'s 4th quarter 2003 filings with the FCC, available at <http://www.universalservice.org/overview/filings/>

- Second, for rural ILEC study areas with very small numbers of lines (regardless of the total number of lines provided by the holding company's other affiliates), the ILEC was also permitted to recover increased access charges. This was originally implemented through a tweak in the jurisdictional separations rules known as Dial Equipment Minutes ("DEMs") Weighting, which assigned a significantly higher proportion of those ILECs' switching costs into the interstate jurisdiction than would have been justified by their relative interstate switch usage. This "DEMs Weighting" mechanism survives today as "Local Switching Support," amounting to over \$400 million per year ^{21/}
- Third, low-cost ILECs that departed from the NECA cost-averaging pools were required to make payments into the pools to support the high-cost ILECs remaining in the pools. These payments, which were phased down during the 1990s but never entirely eliminated, survive today as "Long Term Support," and amount to over \$500 million annually ^{22/}

While the Commission has adopted some reforms to the RLECs' interstate access charge structure, such as reducing those charges from their pre-existing, absurdly high levels to levels that are still high, but more closely approaching those charged by larger ILECs, the ROR system remains the basis for setting the RLECs' access rates. In fact, in order to perpetuate the ROR regulatory system, the Commission established the Interstate Common Line Support ("ICLS") fund targeted to guarantee revenue neutrality for the RLECs at the time of access charge reform ^{23/} The ICLS fund distributes over \$400 million annually.

^{21/} See 47 C.F.R. § 54.301

^{22/} See 47 C.F.R. § 54.303

^{23/} *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, 16 FCC Rcd 19613 (2001) ("MAG Order"), subsequent history omitted see also 47 C.F.R. Part 54, Subpart K

By contrast, the Commission long ago eliminated ROR regulation for AT&T and the large ILECs, and replaced that system with price cap regulation. In that proceeding (discussed at greater length below), the Commission found that ROR regulation gives regulated carriers inefficient investment incentives, impedes innovation, and creates opportunities for carriers to pad their expenses and misallocate costs in order to improperly increase their revenues. On this basis, the Commission decided to eliminate ROR regulation as the basis for AT&T's long-distance rates in 1989, and as the basis for the large ILECs' interstate access charges in 1990. ^{24/} State commissions shared the FCC's aversion to ROR regulation of telecommunications carriers, and all but six of them have abolished ROR for the Bell Operating Companies. ^{25/}

In enacting the 1996 Act, Congress specifically rejected ROR as the basis for setting rates for unbundled network elements ("UNEs"). Section 252(d)(1)(A)(i) directs the FCC and state commissions to set rates for interconnection and network elements "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element . . ." ^{26/} To be sure, the Commission has made it clear that the methodology for setting UNE rates differs from that used for

^{24/} See *AT&T Price Cap Order*, *supra*, *ILEC Price Cap Order*, *supra*.

^{25/} National Regulatory Research Institute, *Retail Regulation of Local Telecommunications Providers (as of April 2002)*, Jan. 2003, available at <http://www.nrrri.ohio-state.edu/programs/markets/pdf/reg-regime-adoption-by-state-map.pdf>.

^{26/} 47 U.S.C. § 252(d)(1)(A)(i).

determining universal service support ^{27/} Nonetheless, it is notable that the Supreme Court, in upholding the Commission's initial order rejecting the use of embedded costs in setting UNE rates, specifically noted the problematic nature of ROR regulation ^{28/} The Commission again "reaffirm[ed] [its] commitment to forward-looking costing principles" and declined to open any inquiry into "alternative pricing methodologies that rely in whole or in part on embedded costs" in its recent *TELRIC NPRM* ^{29/}

B. The Commission Has Repeatedly Committed to Transitioning High-Cost Universal Service Support To A Forward-Looking Cost-Based System.

In implementing the 1996 Act's universal service policy, the Commission has repeatedly committed itself to eliminating the pre-1996 high-cost mechanisms based on embedded costs and ROR regulation, and replacing them

^{27/} *TELRIC NPRM*, ¶ 46, *USF Inputs Order*, 14 FCC Rcd 20156, 20172, ¶ 32

^{28/} *Verizon v. FCC*, 535 U.S. at 512 ("[T]he temptation would remain to overstate book costs to ratemaking commissions and so perpetuate the intractable problems that led to the price-cap innovation"), *id.* at 517-18 ("the 'book' value or embedded costs of capital presented to traditional ratemaking bodies often bore little resemblance to the economic value of capital"), *id.* at 518 ("[B]ook costs may be overstated by approximately \$5 billion") (quoting *FCC Releases Audit Report on RBOCs' Property Records*, Report No. CC 99-3 (rel. Feb. 25, 1999)). See also *TELRIC NPRM*, ¶ 40 n.82, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499, 15846, ¶ 679 (1996) ("*Local Competition Order*"), *subsequent history omitted* ("Adopting a pricing methodology based on forward-looking, economic costs best replicates, to the extent possible, the conditions of a competitive market. In addition, a forward-looking cost methodology reduces the ability of an incumbent LEC to engage in anti-competitive behavior.")

^{29/} *TELRIC NPRM*, ¶¶ 29, 37. See also *id.*, Separate Statement of Chairman Michael K. Powell ("Our commitment to retaining a forward-looking approach is unwavering – what we are debating is the extent to which realistic assumptions about the incumbent's network should be included in our pricing rules") (emphasis added), Separate Statement of Commissioner Kevin J. Martin ("I believe that the prices for unbundled network elements should be based on the forward-looking replacement cost of the ILEC's network") (emphasis added).

with high-cost support based on forward-looking cost. In the *Universal Service First Report and Order*, the Commission concluded that the pre-1996 mechanisms "neither ensure that ILECs are operating efficiently nor encourage them to do so" and are "contrary to sound economic policy." ^{30/} The Commission found that, for small rural carriers as well as for non-rural carriers, "basing support on forward-looking economic cost . . . will require telecommunications carriers to operate efficiently and will facilitate the move to competition in all telecommunications markets." ^{31/} The Commission elaborated on its view that a forward-looking mechanism would be consistent with the Act and better serve the statutory objectives:

Consistent with the Joint Board's recommendation, we anticipate, however, that forward-looking support mechanisms that could be used for rural carriers within the continental United States will be developed within three years of release of this Order. We conclude that a forward-looking economic cost methodology consistent with the principles we set forth in this section should be able to predict rural carriers' forward-looking economic cost with sufficient accuracy that carriers serving rural areas could continue to make infrastructure improvements and charge affordable rates. Like the Joint Board, we conclude that calculating support using such a forward-looking economic cost methodology would comply with the Act's requirements that support be specific, predictable, and sufficient and that rates for consumers in rural and high cost areas be affordable and reasonably comparable to rates charged for similar services in urban areas. Moreover, such a mechanism could target support by calculating costs over a smaller geographical area than the study areas currently used. In addition, we find that the use of mechanisms incorporating forward-

^{30/} *Federal-State Joint Board on Universal Service*, First Report and Order, 12 FCC Rcd 8776, 8934-35, ¶ 292 (1997) ("*Universal Service First Report and Order*"), subsequent history omitted. See also *id.* at 8934-35, ¶ 292 ("Indeed, by guaranteeing carriers recovery of 100 percent of all loop costs in excess of 150 percent of the national average loop cost, the current high-cost funding mechanisms effectively discourage efficiency.")

^{31/} *Id.*